



October 13, 2011

Honorable Mark Leno, Chair  
Joint Legislative Budget Committee  
Senate Budget & Fiscal Review Committee

Honorable Bob Blumenfield, Chair  
Assembly Budget Committee

Honorable Christine Kehoe, Chair  
Appropriations Committee

Honorable Felipe Fuentes, Chair Senate  
Assembly Appropriations Committee

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**Michael Rossi**

**Matthew Toledo**

**Roelof van Ark**  
CEO

**Re: AB 115 Report: Financial Plan Update**

Pursuant to the requirements of AB115 (Committee on Budget) Ch. 38 (statutes of 2011), Section 8(b) the California High-Speed Rail Authority respectfully submits this attached report.

Sincerely,



Roelof van Ark

**Cc:**

- Honorable Bob Huff, Vice Chair, Senate Budget and Fiscal Review Committee
- Honorable Jim Nielsen, Vice Chair, Assembly Budget Committee
- Honorable Joe Simitian, Chair, Senate Budget and Fiscal Review Subcommittee No.2
- Honorable Gilbert Cedillo, Chair, Assembly Budget Subcommittee No. 5
- Mr. Mac Taylor, Legislative Analyst
- Ms. Keely Bosler, Staff Director, Senate Budget and Fiscal Review Committee
- Mr. Bob Franzoia, Staff Director, Senate Appropriations Committee
- Mr. Seren Taylor, Staff Director, Senate Republican Fiscal Office
- Mr. Craig Cornett, Senate President pro Tempore's Office
- Mr. Christian Griffith, Chief Consultant, Assembly Budget Committee
- Mr. Geoff Long, Chief Consultant, Assembly Appropriations Committee
- Mr. Eric Swanson, Staff Director, Assembly Republican Fiscal Committee
- Ms. Deborah Gonzalez, Policy & Fiscal Director, Assembly Republican Leader's
- Mr. Christopher W. Woods, Assembly Speaker's Office
- Mr. Brian Kelly, Policy Director, Senate Pro Tem Darrell Steinberg
- Mr. Josh Tooker, Legislative director, Senator Alan Lowenthal
- Ms. Julie Sauls, Chief of Staff, Senator Jean Fuller
- Ms. Kristen Stauffacher, Legislative Director, Senator Joe Simitian

JERRY BROWN  
GOVERNOR



- Ms. Carrie Cornwell, Chief Consultant, Senate Transportation & Housing Committee
- Mr. Art Bauer, Consultant, Senate Transportation & Housing Committee
- Mr. Bob Hartnagel, Chief of Staff, Senator Mark Leno
- Mr. Barry Steinhart, Senior Legislative Aide, Senator Mark Leno
- Ms. Laura Ortega, Chief of Staff, Senator Tom Berryhill
- Mr. Brent Finkel, Legislative Director, Senator Tom Berryhill
- Mr. Martin Radosevich, Legislative Director, Senator Michael Rubio
- Ms. Kelly Garman, Legislative Director, Senator Bob Huff
- Ms. Erica Martinez, Transportation Policy Consultant, Speaker John Perez
- Ms. Janet Dawson, Chief Consultant, Assembly Transportation Committee
- Mr. Lucas Frerichs, Legislative Director, Assembly Member Rich Gordon
- Mr. Dillon Gibbons, Chief of Staff, Assembly Member Connie Conway
- Mr. Leigh Carter, Legislative Director, Assembly Member. Connie Conway
- Mr. Will Shuck, Chief of Staff, Assembly Member, Bonnie Lowenthal
- Ms. Allison Ruff, Legislative Director, Assembly Member Bonnie Lowenthal
- Mr. Christian Griffith, Chief Consultant (Transportation), Assembly Budget Committee
- Mr. David Stammerjohan, Legislative Director, Assembly Member, Mike Feuer
- Mr. Les Spahn, Consultant, Assembly Member, Mike Feuer
- Ms. Victoria Grajack, Legislative Director, Assembly Member, Cathleen Galgiani
- Mr. Nick Hardeman, Chief of Staff, Assembly Member, Fiona Ma
- Ms. Elizabeth Watson, Legislative Director, Assembly Member, David Valadeo
- Ms. Colleen Beamish, Chief of Staff, Assembly Member, Robert Blumenfield



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**Roelof van Ark**  
CEO

Honorable Christine Kehoe, Chair  
Appropriations Committee

Honorable Felipe Fuentes, Chair Senate  
Assembly Appropriations Committee

**Re: AB 115 Report: Legal Analysis of the Revenue Guarantee**

Pursuant to the requirements of AB115 (Committee on Budget) Ch. 38 (statutes of 2011), Section 8(a) the California High-Speed Rail Authority respectfully submits this attached report.

Sincerely,

**Roelof van Ark**

**Cc:**

- Honorable Bob Huff, Vice Chair, Senate Budget and Fiscal Review Committee
- Honorable Jim Nielsen, Vice Chair, Assembly Budget Committee
- Honorable Joe Simitian, Chair, Senate Budget and Fiscal Review Subcommittee No.2
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- Ms. Elizabeth Watson, Legislative Director, Assembly Member, David Valadeo
- Ms. Colleen Beamish, Chief of Staff, Assembly Member, Robert Blumenfield



# **California High-Speed Rail Authority**

## **Report in Response to AB 115, Chapter 38 of the Statutes of 2011**

**October 13, 2011**

*\* Submitted pursuant to Section 8 of Chapter 38 of the Statutes of 2011*

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## Response to Part (a)

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*(a) A complete legal analysis of the revenue guarantee or other mechanisms to reduce the operator's risk that the authority indicates it would provide to the operator.*

*To mitigate risk, the authority shall provide an analysis of the revenue contribution to the project from the private operator with and without a revenue guarantee or other mechanism to reduce the operator's risk.*

*The authority shall discuss alternative financing approaches to make up for any lost revenue in the case of no revenue guarantee or other mechanisms to reduce the operator's risk.*

### Introduction

This analysis in response to part (a) covers the following topics:

- Background
- Current Approach
- Updated Projections
- Conclusion regarding Legal Analysis
- Alternative Scenarios

### Background

The 2009 Business Plan for the California High-Speed Rail program (the program, or system) included discussion of leveraging private investment prior to commencing revenue operations. Consistent with the experience of other countries that have sought private sector investment, the 2009 Business Plan made reference to needing a “form of revenue guarantee that would guarantee to the private sector participants that a minimum level of revenues would be received in the event that system revenues are significantly lower than forecasted.” The 2009 Business Plan went further to comment that “[w]ithout some form of revenue guarantee from the public sector, it is unlikely that private investment will occur at this level until demand for California’s high-speed rail is proven.”

The April 2010 Addendum to the Business Plan included additional discussion of this issue and the potential role such a guarantee might have in the system’s financing plan. In particular the Addendum distinguished the proposed revenue guarantee from an operating subsidy, making note that a revenue guarantee would be structured as a contingent liability for the express

purpose of funding a portion of the operator's previously-identified capital financing costs in the event certain benchmarks were not met. The revenue guarantee was to be structured to exclude subsidy of operating costs.

### **Current Approach**

At this time, the California High Speed Rail Authority (Authority) has undertaken additional analysis of phased implementation options and the potential timing of private investment. Based on recent high-speed rail transactions and the responses received from the Authority's latest Request for Expressions of Interest (RFEI), the Authority has determined that attracting private capital investment prior to proving revenue operations without some form of revenue guarantee would be extremely expensive, if it was possible. While not eliminating the possibility that private investment would be achieved at an earlier stage, the Authority is planning for a more likely market scenario in which private capital is attracted based on the revenues of the project once revenues are proven. This transaction would be timed and structured such that an external revenue guarantee is not needed. This represents a different approach than was contemplated in the 2009 Business Plan and the April 2010 Addendum.

Under the Authority's current approach, funding for the Initial Operating Section (IOS) of the HSR system would be obtained through state and federal sources. Private-sector investment for construction of the IOS is not considered likely due to the magnitude of the construction work and the uncertainty around commissioning what likely will be the first true high-speed rail system in the U.S.

Operation of the IOS would commence prior to the point at which the private sector would be expected to make an investment to assist with construction to expand the system. Therefore, for the IOS phase of implementation the Authority expects to contract for operating and maintenance services as authorized under the Authority's enabling statute. This approach would involve relatively short-term contracts to serve the state until stable operations of the IOS are reached and longer-term concession or other similar contracts can be implemented together with private investment.

The initial service providers would not be expected to make any major capital investment, but rather would be providing a service under terms of a service contract for which any financing would be incidental. These short-term contracts would be paid by the Authority from IOS ridership and any other project revenues, which, as described below, are projected to be more than sufficient to pay the compensation owed to the operator. Accordingly, no revenue guarantee or other similar mechanism is intended to be provided by the Authority.

Furthermore, at the stage where private investment is expected to be obtained to build additional sections, the Authority projects it will have a proven track record of IOS ridership and revenues, and therefore anticipates it will be able to proceed without providing a revenue guarantee or other similar mechanism.

### **Updated Projections**

The Authority has undertaken updated projections for ridership revenues and operating and maintenance costs associated with a phased implementation plan for the system. The draft 2012 Business Plan will contain details about these projections, which involve ridership revenue projections and operations and maintenance expense projections for three different ridership demand scenarios – high, medium, and low – and the variables that are common and distinct between them.

Most importantly, these projections have demonstrated that the resulting anticipated net operating profit (ridership revenues less operating and maintenance costs) at each phase of passenger service operations is expected to be sufficient to avoid the need for any operating subsidy or other form of revenue guarantee. The projections arising out of each ridership demand scenario show net operating profits starting in the first year of operations. These projections take into account an anticipated five-year ramp-up of ridership and revenue.

### **Conclusion regarding Legal Analysis**

Because the Authority's projections do not result in a need for an operating subsidy, and the Authority's planned business model at each phase of implementation of the system would involve private sector investment only at the point that revenue risk could be transferred, the Authority now anticipates it will be able to proceed without providing a revenue guarantee or other similar mechanism to reduce the risk to the private operator(s).

As a result of the above conclusions, the Authority also has determined that no further legal analysis is necessary at this time, since no revenue guarantee or other similar mechanism to reduce operator risk is intended to be provided.

## **Alternative Scenarios**

AB 115 also sought an analysis of potential “revenue contribution to the project from the private operator with and without a revenue guarantee or other mechanism to reduce the operator’s risk.” However, as noted above, the Authority is not currently intending to provide a revenue guarantee or other similar mechanism in connection with the engagement of private sector operator(s), in light of the planned phased implementation of the system, which would involve a limited role of the private sector in the initial phase of operations and revenue risk transfer in the subsequent stages.

In the event the state or the federal government nonetheless chooses to provide a revenue guarantee in the future, it may be possible, depending on the structure of the guarantee, to accelerate private investment into the system. However, the impact of such a guarantee cannot be assessed until the specific structure was identified, and the relative pricing in the market was assessed at that time. Furthermore, such a mechanism, if created in the future, would need to be structured in compliance with applicable state law.

AB 115 also sought a presentation of the alternative financing scenarios in the event of “any lost revenue in the case of no revenue guarantee or other mechanisms to reduce the operator’s risk.” As noted previously, the Authority’s current approach is not relying on a revenue guarantee or other similar mechanism to reduce the operator’s risk. Therefore, there is no effective means of directly comparing the results with and without such a mechanism.

In the event of any situation leading to private sector contributions to the development of the system falling below the level which is presently anticipated, the alternative financing approach is to either:

- a) reduce the scope or delay the next phase of system development until the performance of the existing system can generate sufficient revenues to support future expansion;
- b) increase government funding of the capital cost of the system in order to reach the point in system development at which the performance of the system can attract sufficient private sector investment; or
- c) utilize a combination of these approaches.

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## Response to Part (b)

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*(b) A financial plan update with alternative funding scenarios.*

*To mitigate risk, the authority shall report on alternative funding options if no significant federal funds are received beyond the federal American Recovery and Reinvestment Act of 2009 (Public Law 111-5) and no revenue guarantee or other mechanisms to reduce the operator's risk are allowable.*

*The plan shall also include construction alternatives for a constrained funding environment, including what investments would be made and construction completed if the non-bond resources only equal bond funding.*

### Introduction

This financial plan update in response to part (b) is required to address the following two alternative scenarios, in brief:

- 1) No significant federal funds are received beyond those already awarded and no revenue guarantee or other similar mechanisms are allowable
- 2) Non-bond sources only equal bond funding

### Background

The Authority is expecting to release its draft 2012 Business Plan in early November 2011. Among other things, this plan describes a phasing plan that would commence California's high-speed rail program with the Initial Construction Section (ICS) in the Central Valley (for which a combined \$6 billion in federal grants and state bond proceeds will fund the full cost of construction). The ICS would be followed by an Initial Operating Section (IOS) extending either north or south from the ICS, with full high-speed service that requires no operating subsidy. Subsequently the system would be extended to the north or the south to connect the Bay Area to the Los Angeles Basin. This phase is described as the Bay to Basin phase, and would be the milestone in system development at which there would be HSR service between the state's major population centers in the north and south. After this phase, expansion could continue to the full Phase 1 and Phase 2 sections as described in Proposition 1A based on availability of sufficient funding and financing tools, including both public and private resources.

## **Alternative Approaches**

The draft 2012 Business Plan includes discussion worth noting here regarding an alternative financing tool that that would allow the state to leverage its existing Proposition 1A commitment to high-speed rail while obtaining a federal debt service subsidy with a much more favorable federal budgetary treatment than direct grant funding. Qualified tax credit bonds (QTCBs) are state and local bonds authorized under Section 54A of the Internal Revenue Code for which the federal government pays all or most of the interest expense through granting annual tax credits in lieu of cash interest.

Such a federally-authorized QTCB program for HSR projects is not in place at this time. New federal legislation would be needed (and possibly companion state legislation) in order for this type of program to be available to California's HSR program or any other HSR project in the U.S. However, it is reasonable to consider this potential financing tool for a number of reasons. In recent years, federal policymakers are paying increasing attention to this policy tool as a means to induce private and other non-federal sources of capital to fund major projects without direct federal spending or growth in the federal government workforce. For instance, QTCB programs already exist for several other categories of facilities, including over \$35 billion of authorized federal tax credit bonds for purposes such as public education, clean renewal energy, energy conservation and forestry conservation. In July 2011 Sens. Wyden (D-OR) and Hoeven (R-ND) co-sponsored the introduction of S. 1426, the Transportation and Regional Infrastructure Project (TRIP) Bonds Act of 2011. This bill would establish a new \$50 billion assistance program for surface transportation projects (including high-speed intercity passenger rail) using QTCBs. Other QTCB proposals also have been considered with varying provisions regarding sources of principal repayment to combine with the federal government's annual tax credits to serve in lieu of cash interest payments.

A federally-authorized QTCB program for HSR would enable the Authority to combine federal and state financing tools to secure a total of 3.5 times the net bond proceeds of the state's general obligation bonds alone. This is because the state's debt service on certain general obligation bonds can be dedicated to secure issuance and principal repayment on QTCBs with a principal amount of approximately 3.5 times the state's general obligation bonds, with a portion being used to purchase the state's own general obligation bonds for the benefit of QTCB investors. The QTCB investors would be repaid through a combination of the federal government's issuance of annual tax credits in lieu of interest on the QTCBs, the state's existing commitment for principal and interest on the general obligation bonds, and the Authority's income earned on the investment of QTCB debt service sinking funds prior to maturity of these

bonds. At the same time, the Authority would receive funds for construction costs from both the proceeds of the original state general obligation bonds and the net proceeds of the QTCBs (after purchase of the state general obligation bonds).

As projected in the draft 2012 Business Plan, a QTCB program would provide slightly more than \$13 billion in additional net proceeds if the program is enacted in time for commencement of the IOS. Most of the bondholders purchasing these QTCBs would be private-sector investors attracted to the favorable federal tax treatment on the bonds.

Although the draft 2012 Business Plan contemplates using the QTCB program along-side traditional federal grants, the program could be established even if no further federal grant funds were made available. Depending on the terms and timing of the establishment of the program, as well as market conditions, the approximately \$13.3 billion in net QTCB proceeds could be combined with the existing \$3.3 billion in federal grant funding for the ICS, and approximately \$8.3 billion in future state bond proceeds to fund approximately \$25 billion in system costs, before consideration of any local government contributions, locally-generated revenues or private investment.

## **Conclusions**

Therefore, if this alternative QTCB financing program is enacted on a timely basis, it would facilitate funding a significant portion of constructing and placing in service an IOS, as presently envisioned. Any remaining “gap” would need to be addressed with a range of measures, such as cost sharing with local governments, project scope/cost reductions, and limited private investment (e.g., vendor financing) in order to complete an IOS and commence revenue service.

At the point that an IOS can be implemented, if no further federal grant funding were received, the ridership revenue from the IOS and any locally-generated revenues or local funding contributions could be used to fund system expansion on an interim “pay as you go” basis. At some point in the future private-sector investment could be obtained when the interim expansion and proven revenue track record were sufficient to attract private capital.

However, if no additional federal funds were received and the QTCB program was not established, it would not appear practical to obtain the necessary funds to “match” the State’s \$9 billion in voter-approved bonds, rendering impractical the ability to use the full \$9 billion of the voter-authorized state general obligation bonds. Under these circumstances, the completion of an IOS (i.e., an operating section that would generate net operating profits) would not appear practical, based on the Authority’s knowledge of the capital costs of various

portions of the system, and the anticipated operating performance of such portions of the system.

Fortunately, the ICS itself has benefits that support its completion. Even if no significant federal funds are received beyond those already awarded to the ICS (and no revenue guarantee or other similar mechanisms are allowable), it still would be possible for California to move Amtrak's *San Joaquin* service from its present Burlington Northern Santa Fe (BNSF) host infrastructure onto the ICS. Without any additional improvements, this will reduce travel times on the *San Joaquin* service between northern and southern California - already one of Amtrak's five busiest corridors in the nation - by approximately 45 minutes. Such a change also would offer significant operating and safety benefits to the "intermediate high-speed" intercity rail operation, and should increase ridership and thereby reduce the need for the existing subsidy levels. To achieve this, track connections would be built to connect the ICS to the BNSF freight line at the northern and southern ends, and minimum rail core systems of signaling, Positive Train Control (PTC), and other investments would be made to augment the base ICS infrastructure. At this stage, electrification of the route would not be required as the Amtrak service is diesel-hauled.

To comply with the FRA requirement for assuring operational independence (referred to as "Independent Utility" in the ARRA funding agreements), Interim Use Reserves have been established by the Authority together with the FRA for the possible interim connection to the BNSF railroad mainline plus associated costs for Positive Train Control (PTC) and interim track maintenance. The funds allocated to the Interim Use Reserves are to be 100 percent federal funds. This allocation does not alter or affect the overall federal share associated with funding the ICS. A total of \$108 million will be aside for the Interim Use Reserves, which amount has been determined to be sufficient to complete the additional capital investments necessary to allow for the provision of interim Amtrak *San Joaquin* service in this corridor.

Under the terms of the federal grants, the following contingency plans will apply.

- If at some point before construction of the ICS is substantially complete the FRA and the Authority mutually anticipate and agree that there will be a significant delay in securing the funds required to complete the investments needed to build and operate the Initial Operating Section (IOS), the federal funds set aside in the Interim Reserve Funds will be utilized to cover the capital investments necessary to allow for the ICS to be placed in use for interim service. No state bond funds would be applied to construct such a connection. This interim service and associated maintenance facilities would not be provided, funded or constructed by the Authority. This would not constitute true high-speed train service (220MPH) although the Amtrak *San Joaquin* service could be

upgraded to 125MPH which is defined as a “high-speed” service within the US-DOT. The Authority would not operate the interim service.

- On the other hand, if the FRA and the Authority mutually agree that sufficient funds are anticipated to be available to complete the investments necessary to complete an IOS for high speed train operations, then the FRA may authorize the Interim Reserve Funds to be reallocated for additional investment in building out the program, including for environmentally-cleared segments adjacent to the ICS, with the mutual agreement of the Authority and the FRA.

As rail infrastructure can be used for extended periods of time, and does not age if reasonably maintained, at any stage in the future, when additional funding could become available, the ICS could be extended in either a southerly or northerly direction. This would ensure completion of the IOS and initiate a true high-speed rail service, for which the ICS in the Central Valley would be the "backbone." The ICS also would serve as the test facility for all high-speed rail core systems such as rolling stock, power supply and catenary, signaling and control systems, switches and systems integration, all of which need to be tested at speeds of greater than 220 miles per hour before passenger service can be initiated. This would be the first such test location in the whole of the nation, offering the state additional benefits once true high-speed rail is initiated in the USA.